BWAB INCORPORATED

IBLA 87-290 Decided April 25, 1989

Appeal from a decision of the Director, Minerals Management Service, affirming a letter-decision of the Chief, Royalty Valuation and Standards Division, requiring calculation of royalties based on the value of liquid hydrocarbons and residue gas produced from onshore oil and gas leases. MMS-85-0128-O&G.

Affirmed in part, set aside in part, and remanded.

1. Oil and Gas Leases: Royalties

Where during an appeal from a decision of the Director, MMS, which concluded that the proper value of residue gas for royalty computation purposes is the highest applicable ceiling price for that gas in accordance with NTL-5, Congress enacts the NTL-5 Act, the Board will set aside that decision and remand the case for a recalculation of royalty owed in accordance with that statute.

2. Oil and Gas Leases: Royalties

In determining the value for royalty computation purposes of liquid hydrocarbons and residue gas derived from the processing of wet gas removed from a Federal onshore oil and gas lease, MMS is permitted by 30 CFR 206.106 (1986) to deduct not more than two-thirds of the value of the liquid hydrocarbons as the cost of manufacture, in the absence of action by the Secretary increasing the allowance.

APPEARANCES: Michael J. Wozniak, Esq., Denver, Colorado, for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE KELLY

BWAB Incorporated (BWAB) has appealed from a decision of the Director, Minerals Management Service (MMS), dated November 13, 1986, affirming a

June 14, 1985, letter-decision of the Chief, Royalty Valuation and Standards Division, MMS, requiring BWAB to calculate royalties based on the value, determined pursuant to the net realization method, of liquid hydrocarbons and residue gas remaining after processing of wet or casinghead gas produced from various Federal onshore oil and gas leases in Richland County, Montana, and McKenzie County, North Dakota. 1/

The facts in this case are not substantially in dispute. At all relevant times, wet gas has been produced from the subject oil and gas leases and then processed into liquid hydrocarbons and residue gas. On August 9, 1977, BWAB's predecessors-in-interest entered into an exclusive agreement with the Petrolane-Perry Gas Processing Company (Petrolane) for processing of wet gas produced from the subject leases at Petrolane's Mon-Dak gas processing plant. See Exh. 3 attached to BWAB's Oct. 23, 1985, Statement of Reasons (SOR). Under the agreement, following processing of the wet gas, title to all of the liquid hydrocarbons was to vest in Petrolane as consideration for its services, while title to all of the residue gas was to remain in BWAB's predecessors-in-interest until delivery to a purchaser. Id. at 6, 14. Subsequently, on February 13, 1978, those predecessors-in-interest contracted with the Montana-Dakota Utilities Company (MDU) for the purchase of all of this residue gas, subject to certain quality restrictions. See Exh. 4 attached to BWAB's Oct. 23, 1985, SOR. Under the contract, MDU agreed to pay for gas delivered to its pipeline system. Id. at 3.

On April 10, 1984, BWAB entered into an exclusive agreement with the Koch Hydrocarbon Company (Koch) for processing the wet gas produced from the subject leases at Koch's McKenzie gas processing plant. See Exh. 7 attached to BWAB's Oct. 23, 1985, SOR. This agreement replaced the previous agreement with Petrolane. Under the agreement, title to the gas and all of its constituent components is to vest in Koch at the point of delivery of the gas to Koch. Id. at 4. In return, Koch is generally required to pay BWAB under the agreement "an amount equal to thirty percent (30%) and twenty percent (20%) of the net sales proceeds received for the residue gas and liquefiable hydrocarbons, respectively, both saved and sold which is attributable to [BWAB's] gas." Id. at 12. The net sales proceeds of the remainder of residue gas and liquid hydrocarbons is allocated to Koch, as consideration for its services. In addition, the agreement provides that Koch may elect at any time to have BWAB retain title to and sell all or a portion of the residue gas. Id. at 15. However, the proceeds of any sale by BWAB are allocated according to BWAB's and Koch's shares. Id. at 15-16.

Effective January 1, 1985, BWAB's predecessors-in-interest amended the February 13, 1978, contract for the purchase of residue gas from the subject leases, substituting the Williston Basin Interstate Pipeline Company (WBI)

1/ BWAB states that the case involves production from the following 23 oil and gas leases in which it owns interests: 53-032413, 53-045922, 53-045923, 54-037742, 55-017226, 55-032654, 55-032737, 55-035150, 55-038034, 84-001484, 84-002282 through 84-002284, 84-005817, 84-006639, 84-008195, 84-008196, 84-016408, 84-017505, 84-032662, 84-032791, 84-035719, and 84-036792.

as the purchaser of the gas. See Exh. 6 attached to BWAB's Oct. 23, 1985, SOR. The amended contract sets certain limits on WBI's obligation to purchase gas. Id. at 2. In the event WBI is unable to purchase the specified daily volumes, the amended contract provides that WBI has the right to release such gas from the terms of the contract. However, subject to adequate capacity and payment of suitable fees, WBI agrees under the contract to "transport, exchange, and/or store such gas to the maximum extent possible." Id. at 2-3, 7.

Beginning in February 1983 and continuing until February 1985, BWAB maintains that it was unable to sell all of the residue gas resulting from the processing of wet gas produced from the subject leases and that the unsold gas was placed in storage. See Exh. 2 attached to BWAB's Oct. 23, 1985, SOR at 3. BWAB states that initially it paid royalties only on the basis of the gross proceeds received on the sale of residue gas but that since late 1983 it has also paid royalties on unsold gas, computing its value at MMS' direction according to the "value of unprocessed gas at the wellhead, adjusted for Btu content and applying the NGPA [Natural Gas Policy Act of 1978, 15 U.S.C. || 3301-3432 (1982)] maximum price" (hereinafter referred to as the Btu method). Id. That gas, however, was, according to BWAB, eventually sold at prices considerably less than the value of the gas computed for royalty purposes. Id. Because of that disparity and the adverse economic effect on its operations, BWAB initiated various efforts to redress the situation.

In an October 24, 1984, letter to the Chief, Accounting Operations Division, MMS, BWAB proposed that it pay royalty based on the gross proceeds received by it on the sale of residue gas, thereby deferring the royalty payment for unsold gas until a sale. The Chief, Royalty Valuation and Standards Division, denied BWAB's request in a March 7, 1985, letter, concluding that BWAB was required by Departmental regulations to pay royalty according to the value of all of the production "leaving the lease * * * based upon the designated NGPA price."

By letter dated March 12, 1985, to the Chief, Royalty Valuation and Standards Division, BWAB renewed its request for a royalty "based upon what we are receiving" for residue gas, noting that the wet gas produced at the wellhead was not salable and, as an alternative, proposed tendering a portion of the gas to MMS in payment of the royalty due. In an April 24, 1985, letter, the Chief, Royalty Valuation and Standards Division, again denied BWAB's request to pay royalty based upon gross proceeds actually received and rejected BWAB's proposal that MMS take a portion of the gas in kind, because there was no program which allowed such payment of royalty.

Finally, BWAB, in a May 3, 1985, letter to the Chief, Royalty Valuation and Standards Division, stated that, beginning with the March 1985 sales of residue gas produced from the subject leases, BWAB would pay royalty based upon the gross proceeds received from such sales and would seek a refund of past overpayments of royalty attributable to the disparity between the gross proceeds received for previously stored gas and the value of the gas used for royalty payment. There is no indication that BWAB has initiated such a refund request.

By letter dated June 14, 1985, the Chief, Royalty Valuation and Standards Division, responded to BWAB's May 1985 letter, concluding that MMS had determined that the payment of royalty based on the value of the wet gas at the wellhead was improper because it had become clear that the gas was "processed prior to the delivery of the residue gas to [the purchaser]" and BWAB was "paid on a residue gas basis with liquids being retained by the plant operator as a charge for extraction." The Chief concluded that, under Departmental regulations, the gas was properly valued pursuant to the net realization rather than the Btu method, and stated, "BWAB will be required to pay royalty on one-third (or lessee's portion if greater than one-third) of all liquid hydrocarbon substances extracted from the gas produced from the leasehold, plus royalty on 100 percent of the residue gas remaining after processing." Under this approach, the value of two-thirds or less of the liquid hydrocarbon is considered an allowance for the cost of manufacturing the wet gas, and is not included in the valuation of the liquid hydrocarbons for royalty computation purposes. On July 17, 1985, BWAB appealed to the Director, MMS, from the June 1985 letter-decision of the Chief, Royalty Valuation and Standards Division.

On appeal to the Director, BWAB did not challenge the requirement to pay royalty on residue gas either sold or stored by BWAB, but objected to MMS' valuation of the stored gas based upon the maximum NGPA price for marketable gas. BWAB contended primarily that MMS' valuation of the stored gas was unreasonable, contrary to regulations and longstanding practice of the Department, arbitrary and capricious, and unconstitutional because it was commercially impossible to market the stored gas and, thus, the stored gas had no market value. BWAB concluded that the value of the stored gas for royalty computation purposes was, therefore, "zero" (BWAB's Oct. 23, 1985, SOR at 18). BWAB requested the Director to value the stored gas based on its "negligible market value." Id. at 29.

BWAB also objected to MMS' calculation of royalty based on the value of one-third of the liquid hydrocarbons resulting from the processing of the wet gas allowing only two-thirds of the value as a cost of manufacturing the wet gas. BWAB contended that rigid adherence to the one-third/two-thirds formula for calculating royalties was unreasonable, arbitrary and capricious where, under the August 1977 gas processing agreement with Petrolane, BWAB was allocated no liquid hydrocarbons and where, under the April 1984 gas processing agreement with Koch, BWAB is allocated only 20 percent of the liquid hydrocarbons. BWAB noted that, in both instances, the deduction by the processor for the cost of manufacture exceeded the two-thirds allowance. BWAB requested a computation deduction allowance "reflecting BWAB's actual costs of extracting liquefiable hydrocarbons (but excluding the cost of sweetening, dehydrating and compressing the gas)." Id. at 29. Overall, BWAB requested that the revised calculation of royalty upon residue gas and liquid hydrocarbons "be applied prospectively and retroactively, and that appropriate financial adjustments be made." Id.

In his November 1986 decision, the Director affirmed the June 1985 letter-decision of the Chief, Royalty Valuation and Standards Division. He concluded that, for the period prior to August 1, 1986, MMS properly valued unsold residue gas according to the maximum NGPA price, pursuant to Notice to Lessees and Operators of Federal Onshore Oil and Gas Leases (NTL-5) (42 FR 22610 (May 4, 1977)). For the period beginning August 1, 1986, the Director concluded that, pursuant to NTL-5 as amended on that date (51 FR 26759 (July 25, 1986)) the value of unsold residue gas was to be determined, in accordance with 30 CFR 206.103 (1986). Generally, the Director held that MMS' valuation of the unsold residue gas comported with the Secretary's broad authority to determine the reasonable value of production, irrespective of actual prices received.

Finally, the Director concluded that MMS was bound by 30 CFR 206.106 (1986) to calculate royalty based on the value of one-third or more of the liquid hydrocarbons resulting from processing the wet gas, with an allowance for the cost of manufacture not to exceed two-thirds of the total value of the liquid hydrocarbons. BWAB has appealed from the Director's November 1986 decision.

In its SOR to the Board, appellant principally raises the same two royalty computation questions presented to the Director, viz., the propriety of valuing residue gas produced from the subject leases but not sold based upon the maximum NGPA price, and the propriety of calculating liquid hydrocarbon royalty based on the value of one-third or more of the liquid hydrocarbons recovered from the wet gas, thereby limiting the allowance for the cost of manufacturing to two-thirds of the total value of the liquid hydrocarbons. In addition, appellant challenges the calculation of royalty based on the value of the residue gas "paid to the gas processor" (BWAB's Dec. 23, 1986, SOR at 5). MMS has filed an answer to appellant's SOR.

The determination of the royalty payable to the United States for production from Federal onshore oil and gas leases is governed by provisions of the applicable statute and Departmental regulations. Section 17 of the Mineral Leasing Act, as amended, 30 U.S.C. | 226 (1982), simply requires that royalty be a certain percentage of the "amount or value of the production removed or sold from the lease."

At all relevant times herein, the specific determination of the "amount or value of production" was governed by the following Departmental regulations. For wet gas, 30 CFR 206.105(c) (1986) provided that the value of the gas "shall be either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all commodities, including residue gas, obtained therefrom, whichever is greater." In the case of "liquid hydrocarbon substances" extracted from the wet gas, 30 CFR 206.106 (1986) provided that the value shall be the "value of one-third (or the lessee's portion if greater than one-third) of * * * [such] substances," and that the "value of the remainder is an allowance for the cost of manufacture, and no royalty thereon is required."

These regulations, however, do not define the "aggregate value * * * of all commodities, including residue gas," derived from wet gas (30 CFR 206.105(c) (1986)) or what constitutes the "value of * * * liquid hydrocarbon substances" (30 CFR 206.106 (1986)). Rather, the "value of production" was governed generally by 30 CFR 206.103 (1986). That regulation provided that the value of production

> shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

(30 CFR 206.103 (1986)). It is well established that this regulation afforded the Secretary "considerable latitude" when determining the value of oil and gas production for royalty computation purposes. Hoover & Bracken Energies, Inc., 52 IBLA 27, 33 (1981), rev'd, Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, No. 81-461-T (W.D. Okla. Nov. 18, 1981), rev'd, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984).

Against this statutory and regulatory backdrop, we will first address the propriety of valuing unsold residue gas using the maximum NGPA price. Appellant's principal contention is that MMS improperly required appellant to pay a royalty on its unsold residue gas based on the maximum NGPA price when the unsold residue gas was unmarketable and, thus, had no market value. Appellant bases its contention that there was no market for the gas on the fact that although it was "free to sell the residue gas to any buyer, * * * no buyer [could] be found at any reasonable price" (BWAB's Dec. 23, 1986, SOR at 19).

MMS does not dispute the fact that there was no market for the unsold residue gas from the subject leases. In fact, in a December 16, 1985, memorandum to the Chief, Division of Appeals, Office of Program Review, MMS, at page 2, the Chief, Royalty Valuation and Standards Division, stated "[t]here is no market for all of the residue gas produced from the plant at the present time. Some of the residue gas produced from the plant is sold." Rather, it is MMS' position that royalty was owed on the unsold residue gas upon removal from the leases and that in accordance with NTL-5 it must be valued for royalty computation purposes at the same value as the gas that was sold.

[1] Under section 17 of the Mineral Leasing Act, royalty is required to be paid upon the value of production at the time of removal or sale from a lease. Where the residue gas produced from the subject leases had a fair market value at the time of removal from the leases, MMS properly computed royalty based on that value, irrespective of whether the gas was then sold.

We base these conclusions on the following analysis. Prior to the 1946 amendment of section 17 of the Mineral Leasing Act, that statutory section provided that royalty would accrue on the amount or value of production. Based on this, the court concluded in United States v. General Petroleum Corporation of California, 73 F. Supp. 225, 258 (S.D. Cal. 1946), aff'd Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950), in
the course of upholding the calculation of royalty upon gas produced and stored for further sale, that: "[R]oyalty accrues as the gas is produced." (Emphasis in original.) That time constitutes the "time for royalty computation." Id. With the 1946 amendment, however, royalty is deemed to accrue on the amount or value of production which is "removed or sold" from a lease (60 Stat. 951 (1946)). See Gulf Oil Corp. v. Andrus, 460 F. Supp. 15, 17 (C.D. Cal. 1978). In the present case, the residue gas has not only been produced but removed from the leases. Thus, royalty must be deemed to have accrued. Accordingly, the gas must be valued for royalty computation purposes.

Generally speaking, the ultimate determinant of the value for royalty computation purposes of gas removed from a Federal oil and gas lease is the fair market value of that production, which value may never have actually been received by the lessee. See California Co. v. Udall, 296 F.2d 384,
388 (D.C. Cir. 1961); Continental Oil Co. v. United States, supra at 817; Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1382 (D. Alaska 1985); aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 107 S. Ct. 1593 (1987); Huskey Oil Co., A-27168 (Nov. 26, 1956).

In the present case, wet gas was removed from the subject leases and processed into residue gas and liquid hydrocarbons. A portion of residue gas was then sold, and the remainder was stored because there was not sufficient market demand. This does not mean that the unsold gas did not have a fair market value when it was removed from the leases. At that time there clearly was a demand for gas and an available supply. That was sufficient to accord the gas a fair market value upon which royalty is properly computed.

In determining the value of the residue gas at the time of removal from the subject leases, MMS properly relied on 30 CFR 206.105(c) (1986). See Wexpro Co., 106 IBLA 57, 67-69 (1988). That regulation was specifically applicable to the calculation of royalty with respect to wet gas, including the residue gas and liquid hydrocarbon components of that gas, removed from a lease. Under the regulation, the value of the residue gas was to be either as a part of the gross proceeds received by the lessee from the sale of the wet gas or the separate value of the residue gas. When the wet gas was not sold, MMS properly valued the residue gas as a distinct commodity.

In determining the separate value of the residue gas, MMS next properly relied on 30 CFR 206.103 (1986). See Wexpro Co., supra at 67-69. That regulation generally governed the valuation of production. Under the regulation, MMS is to determine the reasonable value of production, giving "due consideration * * * to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters." 30 CFR 206.103 (1986).

In his November 1986 decision, the Director concluded that the residue gas should be valued at the maximum NGPA price pursuant to NTL-5, with respect to the period prior to August 1, 1986. The Geological Survey (predecessor of MMS with respect to royalty valuation matters) had originally promulgated NTL-5 effective June 1, 1977, setting forth therein Departmental policies regarding the value of natural gas for royalty computation purposes. Those policies were in effect at all relevant times herein. 2/ NTL-5 provided that the value of gas "disposed of without sale and for which royalty * * * is due will be calculated in the same manner as the [authorized officer] calculates the value of other gas sold from the lease in accordance with the provisions of this Notice." 42 FR 22611 (May 4, 1977).

In his November 1986 decision, the Director specifically identified section I.A.2. of NTL-5 as the applicable provision governing the valuation of "other gas sold from the lease." That section provided that the value of the gas shall be the higher of either the "price received by the lessee * * * in accordance with the provisions of the applicable sales contract" or the "highest applicable ceiling rate then established by the FPC [Federal Power Commission] for the same vintage gas." Accordingly, the Director affirmed use of the maximum NGPA price to value gas with respect to the period prior to August 1, 1986, where that price was the "highest applicable ceiling rate." In addition, we note that the maximum NGPA price was also the price for residue gas received by appellant under the applicable sales contract. See Exh. 4 attached to BWAB's Oct. 23, 1985, SOR at 4. In these circumstances, it is clear that MMS' valuation of the unsold residue gas according to the maximum NGPA price comported with NTL-5.

However, during the pendency of the present appeal, Congress enacted the Notice to Lessees Numbered 5 Gas Royalty Act of 1988 (NTL-5 Act), P.L. 100-234, 101 Stat. 1719 (1988), on January 6, 1988. In that Act, Congress specifically found that application of NTL-5, prior to its modification on August 1, 1986, had resulted in inequitable situations where lessees had been required to pay royalty for gas produced from Federal onshore oil and gas leases on the basis of the maximum NGPA price even though the actual market value of the gas was below that price. In order to correct these inequities, Congress required that, for the period from January 1, 1982, through July 31, 1986, the value of gas for royalty computation purposes would be the "reasonable value of the product as determined consistent with the lease terms and the regulations codified at part 206 of title 30, Code of Federal Regulations, in effect at the time of production." 101 Stat. 1720 (1988). 3/ Congress further provided for a "case-by-case audit," a

2/ NTL-5 was amended on Aug. 1, 1986 (51 FR 26759 (July 25, 1986)), and finally terminated effective Mar. 1, 1988 (53 FR 1272 (Jan. 15, 1988)), when the Department instituted an entirely new system for valuing gas for royalty computation purposes. See 53 FR 1230 (Jan. 15, 1988). That system will apply prospectively to gas produced on or after March 1, 1988, the effective date of the final rulemaking.

3/ The statute sets forth certain language governing establishment of the "reasonable value" of gas, which language essentially reiterates 30 CFR 206.103 (1986). Thus, Congress provides that "due consideration shall be determination of whether royalties had been overpaid or underpaid and either payment of additional royalties owed or a refund. 101 Stat. 1721 (1988). Thus, Congress effectively provided for a retroactive adjustment in the valuation of gas for royalty computation purposes.

In determining the meaning of the NTL-5 Act, it is important, at the outset, to note that the Act does not expressly preclude the Department from applying NTL-5 to the valuation of gas for the period January 1, 1982, through July 31, 1986. In fact, to the extent that the NTL provides for consideration of the maximum NGPA price, that could properly be regarded as one of the "relevant matters" which can be taken into account under 30 CFR 206.103 (1986), along with the highest price paid for like-quality gas in the same field, the price received by the lessee, and posted prices.

However, in view of the purpose of the Act, it is clear that NTL-5 should not be applied so as to result in use of the maximum NGPA price where that price is "higher than the market value for the gas" (101 Stat. 1719 (1988)). Thus, the statute eschews use of the maximum NGPA price where it is not reflective of market value. However, in certain situations, it may be indicative of market value. See Amoco Production Co., 78 IBLA 93 (1983), aff'd, 627 F. Supp. 1375 (W.D. La. 1986), vacated and remanded, 815 F.2d 352 (5th Cir. 1987); Wheless Drilling Co., 13 IBLA 21, 80 I.D. 599 (1973).

Moreover, the statute specifically indicates that use of the maximum NGPA price may be appropriate where that price was "required * * * under a gas sales contract" and the lessee received less than that amount because it failed to collect according to that value and not as a result of market considerations. 101 Stat. 1721 (1986). While that is not the situation here, nevertheless, this exception to the statute indicates that the maximum NGPA price may be properly relied upon where it is incorporated into an applicable sales contract. That is the case here. 4/

fn. 3 (continued)
given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per thousand cubic feet or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality gas, or other products produced and sold from the field or areas where the leased lands are situated will be considered to be a reasonable value." 101 Stat. 1720 (1988).

4/ Where the maximum NGPA price constitutes the price under the applicable sales contract, it may be considered applicable to the unsold residue gas involved herein simply under the language of the NTL-5 Act reiterating 30 CFR 206.103 (1986) to the extent that due consideration should be given

Having said all this, however, we consider the proper approach to be to defer Board determination of the appropriate value for royalty computation purposes of the residue gas involved herein, under the NTL-5 Act, in favor of an initial determination by the Director. Thus, we hereby set aside the Director's November 1986 decision to the extent that he concluded that the unsold residue gas was properly valued for the period prior to August 1, 1986 according to the maximum NGPA price, in accordance with NTL-5, with no consideration of the NTL-5 Act, and to remand the case to the Director for a recalculation of the royalties owed in accordance with that Act. See Wexpro Co., supra at 70; Kerr-McGee Corp., 106 IBLA 72, 82 (1988). 5/

The next question concerns the propriety of limiting the allowance for the cost of manufacturing to the value of two-thirds of the liquid hydrocarbons derived from processing the wet gas produced from the subject leases. Appellant contends that MMS' limitation on the manufacturing cost allowance was arbitrary and capricious because from 80 to 100 percent of the liquid hydrocarbons and 0 to 70 percent of the residue gas had been allocated to the processor as part of the cost of manufacturing the wet gas, and MMS had the discretionary authority to increase the allowance commensurate with the actual cost as determined in arm's-length transactions. MMS responds that the manufacturing cost allowance is limited by 30 CFR 206.106 (1986) to two-thirds of the value of liquid hydrocarbons, and that an increase in that allowance can only be approved by the Secretary pursuant to 43 CFR 3103.3-1(c) (1986).

The August 1977 and April 1984 gas processing agreements provided, respectively, that 0 and 70 percent of the residue gas and 100 and 80 percent of the liquid hydrocarbons were to be allocated to the processor as consideration for its services. Thus, in the latter instance, 70 percent of the value of the residue gas and, in both instances, more than two-thirds of the value of the liquid hydrocarbons was considered by the parties to the agreements as the cost of processing the wet gas produced from the subject leases. However, in valuing the liquid hydrocarbons and residue gas, MMS
deducted as the cost of manufacture only two-thirds of the value of the liquid hydrocarbons.

[2] The deduction of appropriate manufacturing costs in valuing the by-products of wet gas produced from a Federal oil and gas lease is a basic tenet of royalty valuation. As stated by the court in United States v. General Petroleum Corporation of California, supra at 254:

fn. 4 (continued)
to the "highest price paid for a part or for a majority of production of like quality in the same field" (101 Stat. 1720 (1988)).
5/ In his November 1986 decision, the Director also ruled, with respect to the period beginning Aug. 1, 1986, that the residue gas should be valued in accordance with 30 CFR 206.103 (1986), pursuant to NTL-5 as amended on that date. Appellant has not specifically challenged this ruling. We note only that the calculation of royalty owed with respect to this time period is not governed by the NTL-5 Act.

> Natural-gas royalties are payable on the gas as it is produced at the well. It is value of that gas which must be determined. Ordinarily the gas as produced contains a certain amount of "casing-head" gasoline. If the gas is processed in an extraction plant, two products result, the natural gasoline and dry residual gas. Since part of the value of the gasoline and dry gas so manufactured is attributable to the extraction process, allowance must be made for the manufacturing costs in order to arrive at the value of the gas as originally produced.

See also 52 L.D. at 11; The California Co., 66 I.D. 54, 56 (1959), aff'd, California Co. v. Seaton, 187 F. Supp. 445 (D.D.C. 1960), aff'd, 296 F.2d 384 (D.C. Cir. 1961); The Texas Co., 64 I.D. 76, 80 (1957). 6/

As noted supra, when liquid hydrocarbons were extracted from the wet gas produced from the subject leases, the computation of royalty with respect to those substances was at all relevant times governed by 30 CFR 206.106 (1986). That regulation specifically required the payment of royalty on the value of one-third or more of the liquid hydrocarbons with the value of the remainder, i.e., two-thirds or less of the liquid hydrocarbons, constituting an allowance for the "cost of manufacture." Id. This represented a regulatory limitation on the manufacturing cost allowance with respect to liquid hydrocarbons. Moreover, at all relevant times herein, neither that regulation nor any other Departmental regulation expressly provided for a manufacturing cost allowance with respect to the residue gas component of the wet gas.

We recognize that there are situations, as is apparently the case herein, where the two-thirds manufacturing cost allowance may significantly differ from the percentages of liquid hydrocarbons and residue gas actually allocated to the processor as the cost of manufacturing pursuant to an arm's-length contract. In 1926, the Department (in one of its earliest codification of the two-thirds manufacturing cost allowance) stated that the value of the liquid hydrocarbons so computed was "assumed" to be the actual value on which royalty could be computed. 52 L.D. at 11; see also 56 I.D. 462, 464 (1937). The Department then continued to operate under that assumption during the relevant time period where the manufacturing cost allowance provided for in 30 CFR 206.106 (1986) was never rescinded and no Departmental regulation ever expressly provided for taking any portion of the value of residue gas or any portion greater than two-thirds of the value of liquid hydrocarbons as the "cost of manufacture." Thus, we must recognize two-thirds of the value of the liquid hydrocarbons as the ceiling on the manufacturing cost allowance where neither MMS nor the Board

6/ The proper allowance for manufacturing costs is, as appellant recognizes, merely the cost of "separating" the two components of the wet gas, i.e., residue gas and liquid hydrocarbons. Supron Energy Corp., 46 IBLA 181, 193 (1980), appeal filed, Supron Energy Corp. v. Andrus, No. 80-0463 JB (D. N.M.). It does not include the cost of sweetening, dehydrating or compressing the gas, or otherwise placing the gas in a marketable condition. See The California Co., supra at 56; The Texas Co., supra at 79-80.

is empowered to disregard a duly promulgated regulation. Conoco, Inc., 103 IBLA 108, 109 (1988); Joseph J.C. Paine, 83 IBLA 145, 147 (1984).

Moreover, neither MMS nor the Board has any authority under 43 CFR 3103.3-1(c) (1986) to increase the manufacturing cost allowance. That authority is retained by the Secretary. Thus, 43 CFR 3103.3-1(c) (1986) provided at all relevant times herein that, in valuing the "gas and liquid products," the allowance for the cost of manufacture may not exceed "two-thirds," except with the approval of the Secretary.

There is no evidence that appellant sought or obtained Secretarial approval of an increase in the manufacturing cost allowance. Appellant contends that the system for allowing manufacturing costs must be sufficiently flexible to take into account actual costs. Yet appellant has not attempted to take advantage of the flexibility already built into the royalty computation process.

Accordingly, we hereby affirm the Director's November 1986 decision to the extent he affirmed the June 1985 letter-decision of the Chief, Royalty Valuation and Standards Division, ordering the calculation of royalty on 100 percent of the value of the residue gas and one-third or more of the value of the liquid hydrocarbons derived from the processing of the wet gas produced from the subject leases.

In summary, we set aside the Director's November 1986 decision to the extent that he approved the calculation of royalties with respect to unsold residue gas derived from the processing of wet gas produced from the subject leases, for the period late 1983 through July 31, 1986, based on the maximum NGPA price of that gas, in accordance with NTL-5, and remand the case to the Director for a recalculation of royalties owed in accordance with the NTL-5 Act. However, we affirm the Director's November 1986 decision to the extent that he affirmed the conclusion that not more than two-thirds of the value of the liquid hydrocarbons also so derived shall be deducted as an allowance for the cost of manufacturing the wet gas produced from the subject leases.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed in part and set aside in part, and the case is remanded to MMS for further action consistent herewith.

John H. Kelly
Administrative Judge

I concur:

R. W. Mullen
Administrative Judge